No. 12,433

In the United States Court of Appeals for the Ninth Circuit

FIRST NATIONAL BENEFIT SOCIETY, A CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

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INDEX

CITATIONS

Cases:

Statutes:

Miscellaneous—Continued

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OPINION BELOW

The memorandum opinion of the Tax Court (R. 54-75) is not reported.

JURISDICTION

This petition for review (R. 76-79) involves federal income tax for the year 1939. The Commissioner determined a deficiency for that year in the amount of $1,135.83. (R. 55.) Notice of the asserted deficiency was mailed by the Commissioner of Internal Revenue on March 14, 1947 (R. 12); and within ninety days thereafter, and on June 9, 1947 (R. 2), petition for review was filed with the Tax Court for redetermination under the provisions of Section 272 of the Internal Revenue Code. The decision of the Tax Court, sus-

taining the Commissioner, was entered September 13, 1949. (R. 76.)

The case was brought to this Court by taxpayer's petition for review filed November 29, 1949 (R. 76-80), pursuant to the provisions of Section 1141 (a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948, and Section 1142, within three months after the Tax Court's decision was rendered.

QUESTIONS PRESENTED

1. Was taxpayer during the year 1939 a life insurance company within the meaning of Section 201 of the Internal Revenue Code?

2. If taxpayer was a mutual insurance company other than life, did the Tax Court err in ruling that the payments made by taxpayer to the State Treasurer of Arizona during the taxable year did not constitute a net addition required by law to be made to reserve funds, and thus not deductible, within the meaning of Section 207 (c)(1)(A) of the Internal Revenue Code?

3. Was taxpayer entitled to an additional deduction under Section 207 (c)(3) of the Code for alleged premium deposits retained for payment of losses, expenses and reinsurance reserves?

4. Was taxpayer, on the cash basis, entitled to deduct the accrued but unpaid portion of its president's salary?

STATUTES AND REGULATIONS INVOLVED

The statutes and Regulations involved are set out in the Appendix, *infra.*

STATEMENT

The Tax Court found the facts as follows (R. 55-64):

The taxpayer is a corporation organized and existing under and by virtue of the laws of the State of

Arizona. The taxpayer filed its federal income tax return for the calendar year 1939 with the Collector of Internal Revenue for the District of Arizona. On its return the taxpayer reported no tax liability. (R. 56.)

During the period involved, the taxpayer was engaged in business under the "Benefit Corporation Law of 1937" of the State of Arizona, being Chapter 36 of the Arizona Session Laws of 1937, and incorporated in the Arizona Code of 1939 as Sections 53-601 to 53-622, inclusive. Its purpose was (R. 56)—

> That the objects and purposes for which said Corporation is formed are: To engage in, conduct and carry on the business and customary activities of a mutual benefit association within the meaning and provisions of Sections 607-608-609-610 of Chapter 14 of Article 3 of the 1928 Revised Statutes of the State of Arizona as the same now exists; * * *

In the articles of incorporation, the taxpayer is given authority to issue certificates of membership in assessment form and guaranteed cost certificates of various types. Its contractual liabilities "upon any one member" was specifically limited in both cases. Its funds were denominated (1) Benefit Fund, (2) General Fund, and (3) Reserve Fund and/or Trust Fund. The funds were described as follows (R. 56-57):

> Benefit Fund and/or Reserve Fund and/or Trust Fund: The Benefit Fund and/or Reserve Fund and/or Trust Fund of the Corporation, consisting of those moneys received shall be used for the purpose of payment of claims originating under and in connection with claims pertaining to all certificate forms, and in addition thereto such funds shall be charged a nominal amount for each claim in connection therewith as expense money as so allocated by all contracts of membership. Such amount to

be determined from time to time as the Board of Directors may deem advisable.

General Fund: The General Fund consisting of the membership fee, semiannual dues, and other portions of money so allocated to said fund from any source whatsoever, and shall be used for general administration purposes of the business in its entirety except payments of death claims, and the General Fund of the Corporation shall in no way be subject for use of payment of any death claims unless at the discretion of the Board of Directors.

Reserve Fund and/or Trust Fund: The Reserve Fund shall be distributed to the Benefit Fund and consist of those moneys allocated to such fund as so specified in the Guaranteed Cost certificates of membership, and such fund shall be used for payment of death claims as so specified membership certificates; and in addition thereto such funds shall be charged a nominal amount for each claim in connection therewith, as expense money as so allowed by all contract of membership. Such amount to be determined from time to time as the Board of Directors may deem advisable.

The scope of the taxpayer's funds was set forth as follows (R. 58-59):

Section I. The funds of the Society which consist of the following: The Benefit Fund and/or Reserve Fund and/or Trust Fund, and such other funds as the Board of Directors may hereafter from time to time determine and establish. A separate accounting for such funds shall be kept in the books of the Society.

Section II. Benefit Fund, and/or Reserve Fund, and/or Trust Fund: The Benefit Fund, and/or Reserve Fund, and/or Trust Fund, which consist of all moneys paid to or coming into the possession of the Society, during the notice period allowed in the certificate and notice for the payment of death assessments made from time to time by order of or

direction of the Board of Directors for the purpose of paying death claims of members, taxes and other necessary expenses incurred in the administration and defense of said fund.

Section III. General Fund: The General Fund which shall consist of such amounts so specified as dues and other renewal moneys collected after the notice period allowed in the certificate and notice for the payment of the death assessments shall be used to defray expenses incidental to the operation of the Society, including salaries, rentals, printing, postage, etc.

Section IV. Reserve Fund and/or Trust Fund: The Reserve Fund and/or Trust Fund, shall consist of those moneys allocated to such fund as so specified in certificate of membership so issued by the Corporation. Such moneys shall be used for payment of death claims in accordance with the terms of the membership certificates and for taxes and other necessary expenses incurred in the administration and defense of said fund.

By amendments to its by-laws the taxpayer was authorized to issue various certificates called Guaranteed Reserve, Juvenile, Family Burial, Family Group, Accident and Health, Joint policy, "Penny a day life", Death Benefit, etc., and various modifications of the certificates already authorized. (R. 59.)

The taxpayer issued Forms H, XXX, XXX-GG, XXX-J, XXX-FG, and A-H-1 typical of membership certificates and insurance policies issued by it during 1939. All of these policies were designated "Guaranteed Reserve Certificates". In all of them appears the provision, "The member shall not be liable for any debts of the Corporation or for any other obligations save and except the premium deposits required hereon and then only so long as the Certificate remains in force and effect". Form H covered death from any cause;

Form XXX covered natural and accidental death and loss of limb; Form XXX-GG covered natural death of member and accidental death of member and beneficiary; Form XXX-J covered natural and accidental death of member and co-member; Form XXX-FG covered natural and accidental death of the member and dependents, while Form A-H-1 covered accidental loss of life and limb, disability benefits, etc. Each policy provided that premium deposits after one year from the date of the policy should consist of the certificate fee and general fund dues and after the payment of the general fund dues the remainder of such deposits should "be placed in a Trust Fund for distribution to the Mortuary Fund as required"; except Form A-H-1 which required the remainder to be distributed to the "claim fund". (R. 59-60:)

All policies contained the clause (R. 60):

> Reserve: The By-Laws of the Corporation require the deposit in an amount not less than fifty per cent (50) of each premium deposit for the purpose of payment of claims and expenses incidental thereto.

The type and number of policies issued by the taxpayer and in force, as of May 31, 1939, were as follows (R. 60):

Type	Number of Policies
Assessment Form	34
Individual	7,253
Family group	2,369
Joint	685
Juvenile	219
Health and Accident	249
Penny a Day	181
Total	10,990

The taxpayer's income during the calendar year 1939 was entirely from premium payments and none of its income was from interest, dividends or rents. (R. 61.)

On June 30, 1937, the taxpayer's board of directors, consisting of M. C. Reese, M. S. Reese and C. W. Reese, authorized the taxpayer to employ M. C. Reese as its general manager for a term of twenty years and pay him for his services a sum equal to ten per cent of the taxpayer's gross income. During the year 1939 Reese earned $18,075.11 pursuant to the employment contract but was paid only $12,000, leaving a sum of $6,075.11 on its books as due to him. (R. 61.)

The taxpayer maintained only one bank account in which all its receipts were placed. No attempt was made by the taxpayer to separate the various expense and reserve funds. The actual segregation was shown only on its books. Its books were maintained on a cash basis and its income tax return was filed on that basis. (R. 61.)

Prior to and during the taxable year the taxpayer relied on its annual premium receipts to pay its current expenditures, including claims. Prior to March, 1947, when the taxpayer became a legal reserve company, no valuation was made of individual policies as a basis of determining the proper legal reserve. As the taxpayer now operates, the policy reserves must build themselves up with interest increases. (R. 61.)

In all its years of operation the taxpayer never levied any assessments against its members or policyholders. (R. 62.)

In showing the financial status of the taxpayer's "Mortuary Fund" during 1939, losses or claims were accrued at the beginning and end of the year. The taxpayer's books and records in other respects conform to the cash basis of accounting. Upon examining the taxpayer's income tax return for the year 1939, showing

no tax liability, the Commissioner held that its contention that it should be classified as a life insurance company under the provisions of Section 201 of the Internal Revenue Code was denied and that it was a mutual insurance company under Section 207 thereof. He then determined an adjusted net income of $6,883.83 as disclosed by the taxpayer's books. The adjustments were made with the following explanations (R. 62-64):

Items deducted in computing net income shown in your audit report not deductible for income tax purposes:

(a) Compensation under M. C. Reese Contract	$3,675.41
(b) Amount deposited with State Treasurer	4,518.71
(c) Accrued losses (Claims) December 31, 1939	47.34
	$8,241.46
(d) Less: Accrued losses (Claims) December 31, 1938 overstated in your audit report	3,323.00
Difference as shown above	$4,918.46

(a) Compensation under M. C. Reese Contract—$3,675.41

The amount claimed as a deduction in your audit report as compensation due M. C. Reese under an alleged employment contract amounts to $18,075.41. The amount actually paid Mr. Reese during the year under said alleged contract amounted to $14,400.00; the difference, $3,675.41, is disallowed for the reason that your books and records are on the cash basis of accounting.

(b) Amount deposited with State Treaurer—$4,518.71

The amount, $4,518.71, deposited with the Arizona State Treasurer during the taxable year does

not constitute additions required by law to be made within the taxable year to reserve funds within the meaning of section 207 of the Internal Revenue Code and therefore is not a proper deduction in computing your taxable net income under that section of the Act.

(c) Accrued losses (claims) at December 31, 1939—$47.34

The amount of accrued losses (claims) at December 31, 1939 shown in your audit report at $4,299.99 has been reduced to $4,252.65. The balance, $47.34, has not been substantiated as proven claims.

(d) Accrued losses (claims) at December 31, 1938—$3,323.00

The amount of accrued losses (claims) at the beginning of the taxable year 1939, shown in your audit report at $5,155.49, has been reduced to $1,832.49, the amount reflected in the computation of your taxable net income for the preceding taxable year 1938 as accrued losses (claims) at the close of that year.

The Tax Court sustained the Commissioner's deficiency determination in its entirety. (R. 76.)

SUMMARY OF ARGUMENT

I

(a) This court has already twice held, with respect to the earlier tax years of 1936-1937 and 1938, that the instant taxpayer is not a life insurance company within statutory provisions identical with Section 201(a) of the Internal Revenue Code. *First Nat. Ben. Soc.* v. *Stuart,* 134 F. 2d 438, certiorari denied, 320 U. S. 211; *First Nat. Ben. Soc.* v. *Stuart,* 152 F. 2d 298, certiorari denied, 328 U. S. 847. Although a different tax year is here involved, the facts do not materially differ and the questions of law are substantially the same as those in-

volved in the earlier cases. The principle of *stare decisis* would appear to be determinative of the instant case. Moreover, the recent decision of this Court in *Commissioner* v. *National Reserve Ins. Co.,* 160 F. 2d 956, with respect to a taxpayer operating under the same state statute as that under which the instant taxpayer operates, holding taxpayer there not to be a life insurance company within the meaning of Section 201(a), likewise may be regarded as controlling here.

(b) Taxpayer did not sustain the burden of proof that more than 50 percent of its reserve funds were held for fulfillment of its life and other contracts, within the meaning of Section 201 (a) of the Internal Revenue Code. Classifying income is not maintaining a reserve, and taxpayer here maintained only one bank account into which receipts from all sources were deposited and from which all disbursements were made. No segregation or allocation was made of receipts except a nominal one on taxpayer's books. Taxpayer made no attempt to separate its various expense and reserve funds. No evaluation was made of individual policies from which a correct legal reserve might have been established.

Moreover, taxpayer's purported reserve, even if it had actually been set up, would not have met the statutory criteria, for under taxpayer's by-laws and in practice, it was subject to invasion and depletion for general expenses and was not set apart exclusively and solely to fulfill its insurance contracts. The Tax Court properly might take into consideration the further circumstance that taxpayer was not formed or operated under the terms of the Arizona statute, which provided for the creation, operation and regulation of life insurance companies.

(c) Taxpayer's so-called "reserve" held by the State Treasurer of Arizona also is not such a reserve fund as is

contemplated by the statute, since it may be invaded and completely wiped out at any time for purposes other than fulfilling its contractual obligations referred to in Section 201 (a) of the Code.

(d) The relevant Treasury Regulations are long standing and have the force of law, and exclude as such reserves as are required to be maintained under the statute, funds to provide for the ordinary running expenses of a business, i.e., solvency reserves. These Regulations are valid, clear, based upon language contained in an opinion of the Supreme Court, and have already obtained express approval of this Court. Thus, they constitute additional ground for sustaining the decision below. However, since taxpayer has not proved the existence of any reserve fund at all, under the language of the statute, strictly without taking into consideration the Regulations, the decision below was correct.

II

The payments made by taxpayer within the taxable year to the Arizona State Treasurer did not constitute a net addition required by law to be made within the taxable year to the reserve funds within the meaning of Section 207 (c) (1) (A), and hence the Tax Court properly denied their deduction, even though taxpayer was, as the Commissioner held, a mutual insurance company other than life, within the meaning of Section 207 of the Internal Revenue Code. The Tax Court was clearly correct in its finding on the record that taxpayer has failed to establish that it was an assessment company and functioning as such during the taxable year. Moreover, an even more serious defect in taxpayer's contention is found in the additional circumstance that whether or not the deposit with the State Treasurer was made by taxpayer as an assessment company, in any

event it was not an addition to "reserve funds", since the deposit with the State Treasurer was subject to depletion for payment of any judgment and interest earned on the deposit might be used for general operating expenses. Thus, the deposit with the state was not exclusively for the fulfillment of insurance contracts.

III

Taxpayer adduced no evidence whatsoever that any premium deposits were required to be made by its members to provide for losses and expenses or that any amount of premium deposits was retained for the payment of losses, expenses and reinsurance reserves whatever, and hence, taxpayer was not entitled to a deduction under the provisions of Section 207 (c) (3) of the Code.

IV

Taxpayer, on the cash basis, was not entitled to deduct the accrued, but unpaid portion of its president's salary, since it showed no reason or basis whatever to support accrual of this single deduction item in order correctly to reflect net income. Moreover, taxpayer failed to comply with long standing Regulations providing that a cash basis taxpayer wishing to take a deduction for a period other than that in which the deduction was paid, must file his return taking the deduction only for the period when paid and attach thereto a statement requesting the Commissioner to allocate it to a different period and setting forth the facts upon which taxpayer bases its claim for such allocation. The failure of taxpayer to comply with the Regulations leaves it without any standing to make any contention in this connection.

ARGUMENT

I

Taxpayer Was Not a Life Insurance Company in the Taxable Year Within the Meaning of Section 201 (a) of the Internal Revenue Code

A

In its brief taxpayer asserts (p. 4):

> The primary issue is, as stated in the memorandum of the Tax Court, whether the petitioner, during the year 1939, was a life insurance company within the provisions of Section 201 of the Internal Revenue Code or was a mutual insurance company other than life within the meaning of Section 207 thereof.

However, this Court has already twice held with respect to earlier tax years that the instant taxpayer is not a life insurance company within statutory provisions identical with Section 201 of the Internal Revenue Code (Appendix, *infra*), and the relevant facts under the instant record do not in any material respect differ from those of the earlier tax years here involved. Moreover, in both earlier cases the Supreme Court denied certiorari upon this taxpayer's application.

Thus, in *First Nat. Ben. Soc.* v. *Stuart,* decided on March 8, 1943, opinion reported as modified on denial of rehearing April 12, 1943, 134 F. 2d 438, certiorari denied, 320 U. S. 211, where the years 1936 and 1937 were involved, this Court held, affirming the District Court for the District of Arizona,[1] that the only possible finding under the evidence there (p. 440) was that the Society did not maintain any reserve for fulfillment of insurance contracts of the kind required in order to

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[1] The opinion of the District Court not officially reported may be found in 30 A.F.T.R. 1659.

qualify as a life insurance company under Section 201 (a) of the Revenue Act of 1936, c. 690, 49 Stat. 1648. As will be pointed out, *infra,* the evidence here does not materially differ and for the same reasons sustains the identical finding of the Tax Court. (R. 67-68.)

Again, the same result was reached in *First Nat. Ben. Soc.* v. *Stuart,* with respect to the instant taxpayer for the year 1938, construing Section 201 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, where this Court once more affirmed the District Court for the District of Arizona,[2] and for the same reasons, in its decision entered on December 11, 1945, rehearing denied January 11, 1946, 152 F. 2d 298, certiorari denied, 328 U. S. 847.

Although a different tax year is here involved from the two earlier cases, the facts do not substantially differ[3] and the questions of law are the same as those involved in the earlier cases—the identical statutory language, the same questions of application with respect to the same taxpayer—and the principle of *stare decisis* would appear determinative of the instant case.

Res judicata was apparently not asserted on behalf of the Commissioner below, and since a different tax year is involved and the facts, even though similar, are not strictly the same as those of the earlier year, the principle of *res judicata* may technically not be applicable. However, under the instant circumstances, what the Court of Appeals for the Sixth Circuit held in *Grand Rapids & I. R. Co.* v. *Blanchard,* 38 F. 2d

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[2] The opinion of the District Court not officially reported may be found in 33 A.F.T.R. 1643.

[3] Thus, the provisions of taxpayer's certificate of incorporation and bylaws quoted here by the Tax Court (R. 56-59) are identical with those construed in the earlier cases. See Transcript of Record on Appeal in 1943 case, No. 10,231, pp. 59, 68-69, 99-100; reprinted also as part of the record in the 1945 appeal, Transcript of Record in case No. 11,039, pp. 47, 117, 126-127, 160-161.

470, 471, with respect to the principle of *stare decisis* is surely here entirely in point:

> Certainly *United States* v. *Grand Rapids & I. R. Co., supra,* is not res judicata of the present controversy, for parties and complete states of fact differ, *but, considering and deciding, as it does, certain contentions, identical in facts, law and application, with those in similar sequential position in this case, it should be followed in the present case on the principle of stare decisis.* * * * (Italics supplied.)

It is our position that the nature of taxpayer's business and of its so-called reserves was not changed in 1939 from what it was in the years 1936 to 1938, inclusive, and that this Court's reasons for holding in the prior cases that taxpayer was not a life insurance company within the meaning of the statute are fully applicable here.

Moreover, even more recently, in *Commissioner* v. *National Reserve Ins. Co.,* decided April 3, 1947, 160 F. 2d 956, this Court, ruling with respect to a taxpayer, which like the instant taxpayer, operated under the Arizona Benefit Corporation Law of 1937 (4 Arizona Code Annotated (1939), c. 53, Art. 6, Sec. 53-601 (Appendix, *infra*)), held that taxpayer in the cited case, for reasons closely similar to those stated by the Tax Court below, with respect to taxpayer here, did not satisfy the definition of "reserve funds" of life insurance companies set forth in the controlling Section 201 (a) of the Internal Revenue Code. The *National Reserve Ins. Co.* case was cited and followed by the Tax Court below (R. 69, 73), and may also be regarded as controlling here.

B

The Internal Revenue Code contains special provisions dealing with insurance companies which are di-

vided for tax purposes into life insurance companies (Section 201), insurance companies other than life or mutual (Section 204), and mutual insurance companies other than life (Section 207, Appendix, *infra*). The Commissioner denied taxpayer's contention that for the taxable year 1939 it should be classified as a life insurance company under the provisions of Section 201 of the Internal Revenue Code, and held that it was a mutual insurance company under Section 207. (R. 14, 62.) As already noted in the Statement, *supra,* the Tax Court sustained the Commissioner's determination on review. One advantage of classification as a life insurance company is that premium receipts are excluded from gross income. Under Section 202 (a) of the Code, the gross income of a life insurance company consists only of income received from interest, dividends and rent, whereas there is no similar limitation with respect to gross income of a mutual insurance company other than life, under Section 207.

Commencing with the Revenue Act of 1921, companies which met the statutory definition of life insurance companies have thus not been required to include premiums in gross income. (R. 65-67.) See *Helvering* v. *Oregon Ins. Co.,* 311 U. S. 267. The statutory definition of "life insurance company" contained in Section 201 (a) of the Code, here controlling, reads as follows:

> (a) *Definition.*—When used in this chapter the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

As this Court held in both the *First Nat. Ben. Soc.* cases, *supra,* under this statutory language, it is not

enough that life insurance contracts are issued, but in addition, the provision with respect to "reserve funds * * * for the fulfillment of such contracts" must be met.

It is well settled that the term "reserve funds" as used in the revenue statutes in connection with life insurance companies, refers to life insurance reserves, in contrast to solvency or ordinary business liability reserves. Thus, as the Supreme Court stated in *Helvering* v. *Inter-Mountain Life Ins. Co.,* 294 U. S. 686, 690:

> The word "reserve" has many meanings. Accounts creating reserves are set up in almost every line of business, and funds evidenced by the book entries are held for many and widely different purposes. As the Act does not permit corporations other than insurance companies to make deductions of the kind here under consideration, "reserve funds" may not reasonably be deemed to include values that do not directly pertain to insurance. In life insurance the reserve means the amount, accumulated by the company out of premium payments, which is attributable to and represents the value of the life insurance elements of the policy contracts.

Commissioner v. *Monarch Life Ins. Co.,* 114 F. 2d 314, 318, 323 (C. A. 1st).

On this issue which the Tax Court regarded as "factual" (R. 68), as to whether or not more than 50 percent of taxpayer's reserve funds were held for fulfillment of its life and other contracts, within the purview of the statute, taxpayer had the burden of proof. *First Nat. Ben. Soc.* v. *Stuart, supra,* 152 F. 2d 298, 299. This burden the Tax Court properly here held that taxpayer not only failed to sustain but that, in fact, the weight of the evidence was strongly against it. (R. 68.)

The ruling of this Court in *First Nat. Ben. Soc.* v. *Stuart, supra,* 134 F. 2d 440, with respect to taxpayer's alleged "reserve" for the years 1936 and 1937 is completely applicable to the record at bar for the taxable year 1939, as follows:

> Appellant contends that the finding of the court below, that it maintained no reserve for the fulfillment of insurance contracts, is not sustained by the evidence. We think the finding is the only one possible under the evidence. The evidence goes no further than to show that appellant classified its income, but *classifying income is not maintaining a reserve.* (Italics supplied.)

Similarly here the trier of the facts found that taxpayer maintained only one bank account, into which receipts from all sources were deposited and from which all disbursements were made. No segregation or allocation was made of receipts except a nominal one on taxpayer's books. Taxpayer made no attempt to separate its various expense and reserve funds. No evaluation was made of individual policies from which a correct legal reserve might have been established. (R. 61, 68.) The statute contemplates in effect a trust fund for policyholders. Here taxpayer did not have or maintain such a fund in fact. It was not invested, it was not interest bearing, it was not set aside, reserved, segregated or earmarked in any way for the holders of certificates. Even if *arguendo,* as stated in the case of *General Life Ins. Co.* v. *Commissioner,* 137 F. 2d 185 (C. A. 5th), (but which we dispute), the Commissioner is not concerned with the adequacy of a reserve, accepted as adequate by state authorities, he is (as there held, pp. 189-190) concerned with its "inviolability", and the tax law requires that a reserve equal to 50 percent of the total reserves be maintained "for the sole and exclusive protection" of policyholders and "ir-

revocably'' dedicated to the payment of claims. Merely calling an item in a ledger account a reserve fund affords no protection whatever for policyholders, and a fund which can be invaded for the payment of general expenses, as well as for insurance claims, is certainly not ''irrevocably'' dedicated for their use to any extent.

Accordingly, here, as in the earlier *First Nat. Ben. Soc.* case, from which quotation is made immediately above, in the first place, the only possible finding under the evidence is that taxpayer maintained no reserve for the fulfillment of insurance contracts. Classifying income is not maintaining a reserve within the meaning of Section 201(a).

Moreover, in the second place, the purported reserve, even if it had actually been set up, would not have met the criteria for a reserve fund contemplated by the statutory definition, for under the taxpayer's by-laws and in practice it was subject to invasion and depletion for general expenses and was not set apart exclusively and solely to fulfil its insurance contracts. Thus, the by-laws provided for payment of the reserve fund for ''taxes and other necessary expenses incurred in the administration and defense of said fund''. (Section II, R. 58, Section IV, R. 58-59.)

Further, in practice taxpayer made no attempt to separate its various expense and reserve funds. It relied on its current premium receipts to pay its current expenditures including claims. (R. 68.) In *Commissioner* v. *National Reserve Ins. Co., supra,* this Court said, with respect to an analogous situation, as follows (p. 960):

> The Company contends that since in neither tax years was its reserve for the ''fulfillment'' of its policy claims an amount less than the 50 percent of its total reserve fund, it has complied with Section

201 (a) of the Code. We do not agree. The fund was held for these five other purposes and hence not for the exclusive purpose of the fulfillment of the obligations of the policies. It is immaterial that possible drains on the reserve did not happen so to reduce it below its mimimum in these particular years.

Thirdly, it is significant that taxpayer was organized originally in 1934 (R. 29) under the Revised Code of Arizona (1928), Sections 607-610, inclusive (Appendix, *infra*) (R. 56, 70), providing for "benefit societies" and "shall not be subject to the provisions of the general insurance laws" (Section 610). During the taxable year it operated as an "existing corporation or association" under the Benefit Corporation Law of 1937, subsequently codified in the Arizona Code of 1939, Section 53-616 (Appendix, *infra*), and similarly "shall not be subject to the provisions of the general insurance laws" (Section 53-615, Appendix, *infra*). On the other hand, the creation, operation and regulation of life insurance companies was covered in Chapter 61 of the Arizona Code of 1939. The Tax Court correctly held this circumstance significant in evaluating taxpayer's attempt to secure the benefit of federal tax exemption as a life insurance company. (R. 70.)

C

Section 53-605 of the Arizona Code (Appendix, *infra*), provides that a benefit corporation shall deposit with the State Treasurer of Arizona $1,000 before receiving its certificate, $1,000 in monthly payments, and shall make further deposits of $1 for each $1,000 of protection until a total of $10,000 shall have been so deposited. However, the deposits so made are subject to a lien for any unsettled final judgment of a court of

Arizona (Section 53-605 (d)) and any interest earned on the deposit or other corporate assets may be used for general operating expenses (Section 53-605 (c) and 53-609 (b)). (Appendix, *infra.*) Hence, contrary to taxpayer's contention (Br. 13-14), it is obvious that the taxpayer's so-called "reserve" held by the State Treasurer of Arizona also is not a "reserve fund" contemplated by the statute, since it may be invaded and completely wiped out at any time for purposes other than fulfilling its contractual obligations referred to in Section 201 (a) of the Code. Indeed, in the *National Reserve Ins. Co.* case, *supra,* this Court has already so ruled with respect to such a so-called "reserve" set up by the identical sections of the Arizona Code. (Pp. 958-960.)

D

Consequently, on the face of the statute alone, without taking into consideration the Treasury Regulations at all, taxpayer has failed to comply with the provisions of Section 201 (a) with regard to maintenance of reserve funds held for the fulfillment of its life and insurance contracts.

Moreover, the relevant Treasury Regulations construing Section 201 add further support to the holding below . Treasury Regulations 103, Sections 19.201 (a)-1 and 19.203 (a)(2)-1 (Appendix, *infra*), are identical with Treasury Regulations 94, under the Revenue Act of 1936, Articles 201 (a)-1 and 203 (a)(2)-1, expressly approved by this Court in *First Nat. Soc. Ben., supra,* 134 F. 2d 438, 439-440.[4] As this Court there held

[4] Successive Regulations since 1921 have been substantially similar. See Articles 661 and 681, Treasury Regulations 62, 65 and 69; Articles 951 and 971, Treasury Regulations 74 and 77; Articles 201 (a)-1 and 203 (a)(2)-1, Treasury Regulations 86 and 101, under the Revenue Acts of 1921, 1924, 1926, 1928, 1932, 1934 and 1938.

(p. 440):

> Under these circumstances "Congress must be taken to have approved the administrative construction and thereby to have given it the force of law." *Helvering* v. *Reynolds Co.,* 306 U. S. 110, 115, 59 S. Ct. 423, 426, 83 L. Ed. 536. See, also, *Helvering* v. *Winmill,* 305 U. S. 79, 83, 59 S. Ct. 45, 83 L. Ed. 52, and cases cited in note 7.

Indeed, far from disapproving the Regulations, Congress has adopted them. In Section 163 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, it amended Section 201 of the Internal Revenue Code to provide a definition of the term "life insurance reserves" (as H. Rep. No. 2333, 77th Cong., 2d Sess., p. 109 (1942-2 Cum. Bull. 372), states) as—

> substantially that contained for many years in the regulations with the addition that the reserves must be based on recognized experience tables.

The classic definition of a reserve fund contained in Section 19.203 (a)(2)-1 of the relevant Treasury Regulations 103, as—

> a sum of money, variously computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims

was taken from *Maryland Casualty Co.* v. *United States,* 251 U. S. 343, 350, as noted by this Court in *Commissioner* v. *National Reserve Ins. Co., supra,* p. 960. Among other things, "for example", as stated in the Regulations:[5]

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[5] Significantly, this quoted clause, in addition to the earlier language of Section 19.203 (a)(2)-1 particularly referred to in the *National Reserve Ins. Co.* case, *supra,* is likewise derived from the *Maryland Casualty Co.* case, p. 350. Indeed, in the earlier form of the Regulations, which is substantially identical with the present form, the *Maryland Casualty Co.* case is explicitly quoted. See Article 681 of Regulations 62, *supra,* under the Revenue Act of 1921.

> it does not include reserves required to be maintained to provide for the ordinary running expenses of a business definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries, reinsurance, and unpaid brokerage; * * *.

Moreover, not only has this Court explicitly approved the Regulations, but so far as any issue relevant to this case is concerned, no question is raised as to their validity in the cases, decided in other circuits, cited on page 11 of taxpayer's brief. Thus, *General Life Ins. Co.* v. *Commissioner, supra,* threw doubt on the validity of the Regulation's actuarial requirements for a reserve fund, but, as we have already shown, the Court stated that the fund was in the nature of a trust and accordingly the case supports the result of the court below. The companion case, *Abilene Life Ins. Co.* v. *Commissioner,* 137 F. 2d 191 (C. A. 5th), was decided on the same basis. *Jones* v. *Oklahoma Ben. Life Ass'n,* 151 F. 2d 505 (C. A. 10th), was expressly limited to the question whether interest which did not accrue to the reserve fund is a use of the fund other than for the payment of claims arising out of the policies, and was in any event expressly distinguished by this Court in the *National Reserve Ins. Co.* case, *supra,* p. 960. *Swift & Company Employes Benefit Ass'n* v. *Commissioner,* 151 F. 2d 625 (C. A. 7th), turned solely on the requirement of the Regulations that the reserve be required by law.[6] *American Ins. Co. of Texas* v. *Thomas,* 146 F. 2d 434 (C. A. 5th), has no materiality to the instant issues at all.

As already noted, since taxpayer has not proved the existence of any reserve fund at all, on the language of the statute alone without taking into consideration the

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[6] In application for certiorari from the decision of this Court, in *First Nat. Ben. Soc.,* 152 F. 2d 298, *supra,* taxpayer asserted an alleged conflict supposed to be posed by these four cases, but, as already noted, the Supreme Court denied certiorari.

Regulations, the decision below was correct. Hence, strictly no question as to the validity of the Regulations is raised here. However, in any event, the Regulations are valid, clear, based upon language contained in the opinion of the Supreme Court in the *Maryland Casualty Co.* case, have already obtained express approval by this Court, and constitute additional ground for sustaining the decision below.

II

The Payments Made by Taxpayer Within the Taxable Year to the Arizona State Treasurer Did Not Constitute a Net Addition Required by Law to Be Made Within the Taxable Year to Reserve Funds Within the Meaning of Section 207 (c)(1)(A) of the Code, and Hence Were Properly Held Not Deductible by the Tax Court

The Commissioner held that taxpayer was a mutual insurance company other than life under Section 207 of the Internal Revenue Code. (R. 14, 62.) Taxpayer argues (Specification of Errors, III, Br. 6, 15-16), that if it is to be so classified under Section 207, it is entitled to a deduction by reason of certain sums paid to the Arizona State Treasurer as a net addition required by law to be made within the taxable year to reserve funds, within the meaning of Section 207 (c)(1)(A) (Appendix, *infra*). During the taxable year taxpayer deposited with the Arizona State Treasurer $4,518.71. (R. 72.) See Code of Arizona, Section 53-605.

In this connection taxpayer argues that it is an "assessment" insurance company (Br. 15) within the meaning of Section 202 (b) of the Internal Revenue Code (Appendix, *infra*), and that the above mentioned sum paid to the State Treasurer constitutes a deposit pursuant to law as additions to reserve funds, deductible under the terms of Section 207 (c)(1)(A).

In the first place, however, the Tax Court was clearly correct in its finding that taxpayer has failed to establish that it was an assessment company and function-

ing as such during the taxable year. (R. 74.) Thus, in all its years of operation taxpayer never levied any assessments against its members or policyholders. (R. 62.) Again, during 1939 it had in force only 34 out of 10,900 outstanding "policies" or .32 plus percent, even labeled "Assessment Forms". (R. 60, 74.) Except for these 34, the remainder of its policies were not subject to assessment, as shown by the facts that the payments were called premiums, the contracts, certificates or policies, and their holders denominated members or policyholders. The Tax Court further observed that even as to the so-called "Assessment Forms", of which only 34 were issued, none, as a matter of fact, was presented in evidence, and their true character could not be determined merely from the name given by taxpayer. (R. 74.)

Furthermore, an even more serious defect in taxpayer's contention is found in the additional circumstance that whether or not the deposit with the State Treasurer was made by taxpayer as an assessment company, within the meaning of the parenthetical clause of Section 207 (c)(1)(A), in any event it was not an addition to "reserve funds" since, for the reasons already given (see Point I, subdivision C, *supra*), the funds provided by Section 52-605 of the Arizona Code are not reserve funds within the meaning of the controlling sections of the Internal Revenue Code. Construing this section, the controlling Treasury Regulations 103, Section 19.207-4 (Appendix, *infra*), provided that the reserve funds defined in Section 207 (c)(1)(A)—

> do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage. Only reserves commonly recognized as reserve funds in insurance accounting are to be taken into

consideration in computing the net addition to reserve funds required by law.

The same Treasury Regulations (Section 19.207-4) further refer to Section 19.203 (a)(2)-1, "for a general definition of 'reserve fund' " discussed, *supra,* in Point I, subdivision D. Accordingly, since the deposit required by the Arizona statute was not made to a "reserve fund", the deduction was properly not allowed. *Commissioner* v. *National Reserve Ins. Co., supra,* pp. 958-960.

III

Taxpayer Failed to Establish That It Was Entitled to Additional Deduction under Section 207 (c)(3)

The Tax Court held that taxpayer had failed to present any evidence proving its claim to certain other deductions under Section 207 (c)(3) (Appendix, *infra*), and therefore was considered to have abandoned the issue relating to them (R. 75). Nevertheless, taxpayer asserts such a contention in its brief here. (Pp. 17-18.) The holding of this Court in *First Nat. Ben. Soc.* v. *Stuart,* p. 299, with respect to a like contention by this taxpayer there is here fully applicable, as follows:

> Appellant alleged, in substance and effect, that, if taxable under § 207 (a), it was entitled to a deduction under § 207 (c)(3) of the Revenue Act of 1938, 26 U. S. C. A. Int. Rev. Acts, pp. 1092, 1093. Appellee denied that appellant was entitled to any such deduction. On this issue, appellant had the burden of proof. Thus appellant had the burden of proving that its members were required to make premium deposits to provide for losses and expenses, and that some amount thereof was returned to its policyholders or was retained for the payment of losses, expenses, and reinsurance reserves. The burden was not sustained. The court properly

> concluded that appellant was not entitled to a deduction under § 207 (c)(3).

There is no evidence whatsoever in the instant record that any premium deposits whatever were made by taxpayer's members to provide for losses and expenses, nor any evidence that any amount of premium deposits were returned to policy holders or "retained for the payment of losses, expenses, and reinsurance reserves." Section 207 (c)(3). Not only is there a complete absence of proof on this point, further, Treasury Regulations 103, Sec. 19.207-6 (Appendix, *infra*), provides—

> The amount of premium deposits retained for the payment of expenses and losses, and the amount of such expenses and losses, may not both be deducted.

Here taxpayer has never alleged or proved any losses or expenses for which it was not granted deduction and for which premium deposits were retained. Deductions are of course allowed only when plainly authorized by the revenue statutes and the taxpayer is subject to a strict burden of proof to establish them. *Helvering* v. *Inter-Mountain Life Ins. Co.,* 294 U. S. 686, 689. As aforesaid, taxpayer here completely failed to sustain this burden.

IV

Taxpayer, Being on the Cash Basis, Is Not Entitled to Deduct the Accrued, But Unpaid, Portion of Its President's Salary

Taxpayer admits that its income tax return was filed on the cash basis. (Br. 19.) It argues here as it did below, that since the Commissioner accrued its unpaid claims, which were reported at the close of the year and upon which no proof of claim had been made, he should have accrued also the unpaid portion of its president's compensation or "salary" and permitted taxpayer to deduct this unpaid amount in the sum of $3,675.41.

(R. 74.) Taxpayer's books and records were maintained on the cash basis. (R. 62.)

Taxpayer does not here (Br. 17), and did not below challenge the action of the Commissioner in accruing its unpaid claims (R. 74-75). The Commissioner, as the Tax Court held, deemed such treatment of the unpaid claims was requisite correctly to reflect taxpayer's true income. (R. 74-75.) The statute expressly affords the Commissioner discretion to make such a change. Thus, Section 41 (Appendix, *infra*), provides that if the method of accounting regularly employed in keeping the books of taxpayer—

> does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income.

Long standing Treasury Regulations further confirm the Commissioner's discretion in this respect. Regulations 103, Sections 19.41-1 and 19.41-2. (Appendix, *infra*).

In any event, as already noted, taxpayer does not contest the correction thus made by the Commissioner to reflect taxpayer's true income. Its sole contention is that as to one particular item of expense on its return out of many others there is to be a deviation from the cash basis. In other words, since the Commissioner made one deviation, taxpayer is entitled to another deviation, namely, the deduction in the taxable year of salary unpaid to its president. Thus, while, on the one hand, it does not dispute the correctness of the treatment of the unpaid claims required by the Commissioner in order fairly to reflect its income, on the other hand, it shows no reason or basis whatsoever, to support accrual of this single deduction item, in order correctly to reflect net income.

Moreover, taxpayer's claim on well settled grounds must fail for an additional reason. Thus Section 43 (corresponding to Section 41, dealing with income items) with respect to deductions, provides:

> SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.
>
> The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

Construing this statutory provision, long standing Treasury Regulations prescribe (Sec. 19.43-1):

> If a taxpayer desires to claim a deduction or a credit as of a period other than the period in which it was "paid or accrued" or "paid or incurred," *he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner together with a complete statement of the facts upon which he relies.* However, in his income tax return he shall take the deduction or credit only for the taxable period in which it was actually "paid or incurred," or "paid or accrued," as the case may be. Upon the audit of the return, the Commissioner will decide whether the case is within the exception provided by the Internal Revenue Code, and the taxpayer will be advised as to the period for which the deduction or credit is properly allowable. (Italics supplied.)

Applying the cognate of the quoted sections of the Code and of the Regulations, the Court of Appeals

for the Third Circuit in *Cassatt* v. *Commissioner,* 137 F. 2d 745, 749, ruled:

> The taxpayer, * * * urges that the Commissioner should have permitted the amortization of the sums here in question * * * under the authority given him by Section 43 of the Revenue Act of 1934, 26 U. S. C. A. Int. Rev. Code, § 43, in order more clearly to reflect the income of Cassatt and Company. But it appears that the taxpayer did not comply with Article 43-1 of Regulations 86 which implements Section 43 by providing that a taxpayer wishing to take a deduction for a period other than that in which it was paid or accrued shall file his return taking the deduction only for the period when paid or accrued and attach thereto a statement requesting the Commissioner to allocate it to a different period and setting forth the facts upon which he bases his claim for such allocation. This regulation is reasonable and within the Commissioner's authority. *Helvering* v. *Cannon Valley Milling Co.,* 8 Cir., 1942, 129 F. 2d 642. The failure of the taxpayer to comply with it leaves him without standing to invoke the provisions of Section 43.

Following the cited case is the holding of the Tax Court in *Your Health Club, Inc.* v. *Commissioner,* 4 T. C. 385, 389.

Similarly, here there is no showing whatsoever that taxpayer returned the asserted deduction on the cash basis and attached thereto a statement requesting the Commissioner to allocate it to a different period and setting forth the facts upon which it based its claim for such allocation, as required by the Regulations. Indeed, the evidence is to the contrary (R. 63), for it appears that taxpayer took the deduction in its return without any such explanation, notice, or request to the Commissioner (R. 14-15, 62-63). Hence, on principle, and as held in the cited case, the failure of the

taxpayer to comply with the Regulations leaves it without standing to invoke the provisions of Section 43.

CONCLUSION

The decision of the Tax Court should be affirmed.

Respectfully submitted.

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APRIL 1950.

APPENDIX

INTERNAL REVENUE CODE:

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

(26 U. S. C. 1946 ed., Sec. 41.)

SEC. 201. TAX ON LIFE INSURANCE COMPANIES.

(a) *Definition.*—When used in this chapter the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

* * * * *

(26 U. S. C. 1946 ed., Sec. 201.)

SEC. 202. GROSS INCOME OF LIFE INSURANCE COMPANIES.

* * * * *

(b) *Reserve Funds Required by Law, Defined.*—The term "reserve funds required by law" includes, in the case of assessment insurance, sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds main-

tained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use.

(26 U. S. C. 1946 ed., Sec. 202.)

SEC. 203. NET INCOME OF LIFE INSURANCE COMPANIES.

(a) *General Rule.*—In the case of a life insurance company the term "net income" means the gross income less—

* * * * *

(2) *Reserve funds.*—An amount equal to 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, except that in the case of any such reserve fund which is computed at a lower interest assumption rate, the rate of 3¾ per centum shall be substituted for 4 per centum. Life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, shall be allowed, in addition to the above, a deduction of 3¾ per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

* * * * *

(26 U. S. C. 1946 ed., Sec. 203.)

SEC. 207. MUTUAL INSURANCE COMPANIES OTHER THAN LIFE.

(a) *Imposition of Tax.*—

(1) *In general.*—There shall be levied, collected, and paid for each taxable year upon the

special class net income of every mutual insurance company (other than a life insurance company) a tax equal to 16½ per centum thereof.

* * * * *

(c) *Deductions.*—In addition to the deductions allowed to corporations by Section 23 the following deductions to insurance companies shall also be allowed, unless otherwise allowed—

(1) *Mutual insurance companies other than life insurance.*—In the case of mutual insurance companies other than life insurance companies—

(A) the net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and

* * * * *

(3) *Mutual insurance companies other than life and marine.*—In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves.

(26 U. S. C. 1946 ed., Sec. 207.)

4 Arizona Code annotated (1939), c. 53, Art. 6:

BENEFIT CORPORATION LAW

53-601. *Short title.*—This act may be cited as the Benefit Corporation Law of 1937. [Laws 1937, ch. 36, § 1, p. 107.]

53-602. *Benefit corporations.*—Corporations, not for pecuniary profit, may be formed to provide

cash benefits for members and cash benefits for the nominees of deceased members, and shall include all corporations, societies and associations operating an insurance business where funds are provided by mutual contributions, periodical payments, dues or assessments, except those hereinafter exempted. [R. S. 1901, § 898; 1913, § 2215; R. C. 1928, § 607; Laws 1937, ch. 36, § 2, p. 107.]

53-603. *Formation.*—(a) Two hundred [200] or more citizens of the United States, residents of this state for at least one [1] year, may form a benefit corporation by filing articles of incorporation, verified by each of them, stating the general objects of the corporation, its principal place of business, the time of its commencement and termination, the names of the directors and officers by whom the affairs of the corporation are to be conducted and the time of their election, the corporation's name (which shall indicate its general character of business and shall not closely resemble the name of any association, life insurance company, or corporation now licensed to do business in this state), and whether private property is to be exempted from liability for the corporate debts.

* * * * *

[R. S. 1901, § 889; 1913, § 2216; R. C. 1928, § 608; Laws 1937, ch. 36, § 3, p. 107.]

53-605. *Deposit of money or security.*—(a) Every benefit corporation organized or operating under the provisions of this act, before receiving a certificate of authority to transact business, shall, in addition to the requirements of section 609b [§ 53-611], deposit with the state treasurer, to be by him held in trust for the benefit and protection of the corporation's members, the sum of one thousand dollars [$1,000]. Thereafter a further sum of one thousand dollars [$1,000], divided into twelve [12] equal monthly payments, beginning thirty [30] days after the certificate of authority is issued, shall be likewise deposited with the state

treasurer. Failure to pay any such monthly payment shall automatically cancel the corporation's certificate of authority.

(b) In addition to said deposits every such corporation shall, not later than February 1, 1940, and on or before February 1 of each year thereafter, deposit with the state treasurer, to be by him held in trust as hereinafter provided, for the benefit and protection of the members of the corporation, a further sum equal to one dollar [$1.00] for each one thousand dollars [$1,000] of protection in force on December 31 of the preceding year, beginning as of December 31, 1939, until a total of ten thousand dollars [$10,000] has been so deposited.

(c) The deposits prescribed by this section shall be subject to withdrawal from the state treasury in whole or in part only on the order of and as directed by the corporation commission, but may, with the commission's approval, be invested in United States or state bonds, which shall be placed with and assigned to the state treasurer and held by him as provided for the original deposits. Subject to approval by the commission any such securities may be exchanged for others of like amounts. The interest on said securities shall be payable to the corporation depositing the same.

(d) Any unsettled final judgment of a court of this state shall be a lien on the deposits of money or securities prescribed by section 608b [§ 53-605], and subject to execution after thirty [30] days from entry of final judgment. If said deposit is depleted thereby it shall be replenished within ninety [90] days.

(e) Said deposit may be considered as a part of any required reserve of the corporation and shall not be subject to withdrawal so long as the corporation has any contract or other liability outstanding. If and when the corporation liquidates, dissolves, or merges with another corporation, and there are no certificates or other liabilities not satisfied or as-

sumed, the deposit shall be returned to the corporation upon the order of the commission, and placed to the credit of the fund from which it was taken or paid to the person who may have advanced it. [R. C. 1928, § 608b as added by Laws 1937, ch. 36, § 5, p. 107.]

53-606. *Benefit certificate.*—(a) Every benefit certificate issued by any such corporation shall specify the maximum amount not exceeding five thousand dollars [$5,000], on the life of any individual, to be paid on the happening of the contingency therein stated, and shall state the basis or amount to be set aside to the mortuary and reserve fund. The certificate, including any written amendment thereto, and, at the option of the corporation, the application therefor, and the by-laws of the corporation, shall constitute the entire contract between the corporation and the member, and the applicant shall see that all facts required to be stated are set forth in the application.

* * * * *

[R. C. 1928, § 608c as added by Laws 1937, ch. 36, § 6, p. 107.]

53-609. *Payments and Funds.*—(a) Every benefit corporation shall provide in its benefit certificate for periodical payments or dues sufficient to pay benefit claims and general operating expenses as stipulated therein.

(b) A mortuary and reserve fund, exclusive of other assets, may be created, out of which may be paid all benefit claims arising under the certificates, the deposits required to be made with the state treasurer as provided by section 608b [§ 53-605], and attorney's fees and necessary expenses arising out of the defense, settlement, or payment of any contested or disputed claim. The residue of payments made by members, after setting aside the amount required for the mortuary and reserve fund, and interest earned by the assets of the corporation, whether deposited with the state treasurer

or otherwise invested, may be used for general operating expenses. [R. S. 1901, § 900; 1913, § 2217; rev., R. C. 1928, § 609; Laws 1937, ch. 36, § 9, p. 107.]

* * * * *

53-613. *Organizations exempted.*—The provisions of this act shall not apply to secret or fraternal societies, lodges, or councils, which conduct their business and secure members on the lodge system exclusively, and having a ritualistic work and ceremonies in their societies, lodges, or councils, nor to any mutual or benefit association organized or formed and composed exclusively of members of any such society, lodge, or council, church or religious society, nor to any association of employees employed by one and the same concern, or its subsidary [subsidiary], nor any labor organization, nor to any life insurance company organized or operating under chapter 36, Revised Code of 1928, nor to any foreign assessment company operating under the general insurance laws of this state. [R. C. 1928, § 609d as added by Laws 1937, ch. 36, § 13, p. 107.]

* * * * *

53-615. *Powers of benefit corporations.*—Any corporation organized under the provisions of this act may contract, sue and be sued by and in its own name, and shall not be subject to the provisions of the general insurance laws, and no law hereafter enacted shall apply to such corporations unless they are expressly designated therein. * * * The by-laws or the benefit certificate may provide for the qualification of members, mode of acceptance, the fees of admission and periodical payments or dues, the expulsion of members for non-payment of any periodical payments or dues, the restoration to membership, the employment and compensation of its agents and other regulations not in violation of this act. [R.S. 1901, §§ 901, 902; 1913, §§ 2218, 2219; cons., R. C. 1928, § 610; Laws 1937, ch. 36, § 15, p. 107.]

53-616. *Existing corporations.*—Any existing corporation or association heretofore incorporated under the provisions of sections 607, 608, 609 and 610, article 3, chapter 14, Revised Code of 1928 [§§ 53-602, 53-603, 53-609, 53-615], shall be deemed to be lawfully incorporated, organized and existing and may continue its corporate existence and transact business under, and avail itself of the provisions hereof without reincorporating or requalifying, except that such corporation shall on or before January 1, 1938, comply with the provisions hereof as to statutory agent, minimum membership, deposits of money or securities, benefit certificate, fidelity bond, and certificate of authority, and shall be subject to examination as herein provided. [R. C. 1928, § 610a as added by Laws 1937, ch. 36, § 16, p. 107.]

Revised Code of Arizona (1928), c. 14, Art. 3:

[607. *Benefit Societies; limitations.* Associations may be formed for the purpose of paying to the nominee of any member a sum upon the death of said member not exceeding three dollars for each member of such association. No such association shall exceed in number five thousand persons. (§ 898, R. S. '01; 2215, R. S. '13.)

§ 608. *Formation.* Such association shall be formed by filing a verified certificate in the office of the recorder of the county in which the principal place of business is to be situated, and filing a like certificate in the office of the corporation commission; such certificate shall state the general objects of the association, its principal place of business and the names of the officers selected to hold for the first three months, and shall be signed by the said officers and verified by at least three of them. (§ 889, R. S. '01; 2216, R. S. '13.)

§ 609. *Assessments.* Said association, upon the death of any member, may levy an assessment, not exceeding three dollars, upon each living member, and collect and pay the same to the nominee of such deceased, and may also provide for annual assess-

ments of members, such annual assessments upon any one member not to be raised above that established at the time such member joined the association. (§ 900, R. S. '01; 2217, R. S. '13, rev.)

§ 610. *Powers; not controlled by insurance laws.* Such association may sue and be sued by its name, may loan its funds and own sufficient real property for its business purposes, and such other real property as it may purchase on foreclosure of its mortgages. Such property so obtained through foreclosure shall be sold and conveyed within five years from the day title is obtained, unless the superior court of the proper county shall, upon petition and good cause shown, extend the time. Such association may make such by-laws as may be necessary for its government and for the transaction of its business, and shall not be subject to the provisions of the general insurance laws. (§§ 901-2, R. S. '01; 2218-19, R. S. '13, cons.)

Treasury Regulation 103, promulgated under the Internal Revenue Code:

Sec. 19.41-1. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 19.42-1 to 19.42-3, inclusive.)

If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Sec. 19.41-2. *Bases of computation and changes in accounting methods.*— * * * All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. But see sections 42 and 43. See also section 48.

* * * * *

Sec. 19.201(a)-1. *Life insurance companies: Definition.*—The term "life insurance company" as used in chapter 1 is defined in section 201(a). In determining whether an insurance company is a "life insurance company" as defined in section 201(a), no reserve shall be regarded as held for the fulfillment of an insurance contract unless it conforms to the definition of "reserve" contained in section 19.203(a)(2)-1.

Sec. 19.203(a)(2)-1. *Reserve funds.*—In general, the reserve contemplated is a sum of money, variously computed or estimated, which, with accretions from interest, is set aside (reserved) as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims. It must be required either by express statutory provisions or by rules and regulations of the insurance department of a State, Territory, or the District of Columbia when promulgated in the exercise of a power conferred by statute, but such requirement, without more, is not conclusive; for example, it does not include reserves required to be maintained to provide for the ordinary running expenses of a business definite in amount, and which must be currently paid by every company from its income if its business is to continue, such as taxes, salaries,

reinsurance and unpaid brokerage; the reserve or net value of risks reinsured in other solvent companies to the extent of the reinsurance; reserve for premiums paid in advance; annual and deferred dividends; accrued but unsettled policy claims; losses incurred but unreported; liability on supplementary contracts not involving life contingencies; estimated value of future premiums which have been waived on policies after proof of total and permanent disability.

In any case where reserves are claimed, sufficient information must be filed with the return to enable the Commissioner to determine the validity of the claim. Reference should be made to the item in which the reserve appears in the annual statement and to the statute or insurance department ruling requiring that such reserves be held. Only reserves which are so required, which are peculiar to insurance companies, and which are dependent upon interest earnings for their maintenance will be considered. A company is permitted to make use of the highest aggregate reserve called for by any State or Territory or the District of Columbia in which it transacts business, but the reserve must have been actually held.

In the case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation, it is required that reserve funds thereon be based upon recognized tables of experience covering disability benefits of the kind contained in policies issued by this particular class of companies. The deduction in respect of such reserve funds (not required by law) is 3¾ percent of the mean of such reserve funds held at the beginning and end of the taxable year.

Sec. 19.207-2. *Gross income of mutual insurance companies other than life.*—The gross income of mutual insurance companies (other than life) consists of their total revenue from the operation of the business and of their income from all other

sources within the taxable year, except as otherwise provided by the Internal Revenue Code. Gross income includes net premiums (that is, gross premiums less returned premiums on policies canceled and premiums on policies not taken), investment income, profits from the sale of assets, and all gains, profits, and income reported to the State insurance departments, except income specifically exempt from tax. * * * A net decrease in reserve funds required by law within the taxable year must be included in the gross income to the extent that such funds are released to the general uses of the company and increase its free assets. Any net decrease in reserves shall be added to the gross income, unless the company shall show that such decrease resulted from the application of reserves to the purposes for which they were established.

Sec. 19.207-3. *Deductions allowed mutual insurance companies other than life insurance companies.*—Mutual insurance companies (other than life insurance companies) are entitled to the same deductions from gross income as other corporations, and also to the deduction of the net addition required by law to be made within the taxable year to reserve funds and of the sums other than dividends paid within the taxable year on policy and annuity contracts. Mutual insurance companies are not entitled to the deductions allowed by section 204 (c), but (except in the case of life insurance companies) are entitled to the deductions allowed by section 23. Relative to the net operating loss deduction allowed by section 23 (s), see section 19.208-1 (c). "Paid" includes "accrued" or "incurred" (construed according to the method of accounting upon the basis of which the net income is computed) during the taxable year, but does not include any estimate for losses incurred by not reported during the taxable year.

Sec. 19.207-4. *Required addition to reserve funds of mutual insurance companies (other than life).*—

Mutual insurance companies, other than life insurance companies, may deduct from gross income the net addition required by law to be made within the taxable year to reserve funds, including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds. Reserve funds "required by law" include not only reserves required by express statutory provisions but also reserves required by the rules and regulations of State insurance departments when promulgated in the exercise of an appropriate power conferred by statute, but do not include assets required to be held for the ordinary running expenses of the business, such as taxes, salaries, reinsurance, and unpaid brokerage. Only reserves commonly recognized as reserve funds in insurance accounting are to be taken into consideration in computing the net addition to reserve funds required by law. In the case of a fire insurance company the only reserve fund commonly recognized is the "unearned-premium" fund. For a general definition of "reserve fund" see section 19.203(a)(2)-1. * * *

Sec. 19.207-6. *Special deductions allowed mutual insurance companies (other than life or marine).*— Mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life and mutual marine insurance companies), which require their members to make premium deposits to provide for losses and expenses, are allowed to deduct from gross income the aggregate amount of premium deposits returned to their policyholders or retained for the payment of losses, expenses, and reinsurance reserves. In determining the amount of premium deposits retained by a mutual fire or mutual casualty insurance company for the payment of losses, expenses, and reinsurance reserves, it will be presumed that losses and expenses have been paid out of earnings and profits other than premiums to the extent of such earnings and profits. If, however, any portion

of such amount is applied during the taxable year to the payment of losses, expenses, or reinsurance reserves, for which a separate allowance is taken, then such portion is not deductible; and if any portion of such amount for which an allowance is taken is subsequently applied to the payment of expenses, losses, or reinsurance reserves, then such payment cannot be separately deducted. The amount of premium deposits retained for the payment of expenses and losses, and the amount of such expenses and losses, may not both be deducted. * * *

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